Revenue Ruling 58-234

SECTION 1234.-OPTIONS TO BUY OR SELL

The amount (premium) received by the writer (issuer or optionor) for granting a "put" or "call" option, which is not exercised, constitutes ordinary income, for Federal income tax purposes, under *section 61 of the Internal Revenue Code of 1954*, to be included in his gross income only for the taxable year in which the failure to exercise the option becomes final.

Where a "put" option is exercised, the amount (premium) re-received by the writer (issuer or optionor) for granting it constitutes an offset against the option price, which he paid for the securities involved upon its exercise, in determining the (net) cost basis to him of the securities that he purchased pursuant thereto, for subsequent gain or loss purposes.

Where a "call" option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it is includible by him, with the option price which he received for the securities involved upon its exercise, in the (total) amount realized by him for the securities that he sold pursuant [*2] thereto, for the purpose of determining his gain or loss on their sale. For such purpose, if the amount (premium) received for granting a "call" option is, under its terms, applicable, upon its exercise, on, to, or against the option price specified therein, such price thus adjusted (reduced) is considered the real option price.

On the sale by the option holder (optionee) of the stock involved in a "put" option, upon its exercise, the cost (premium) of the option to him should be offset against the option price, thereupon received or accrued, in computing the (net) amount realized by him for the stock that he sold pursuant thereto, for the purpose of determining his gain or loss on its sale.

The above holdings do not apply to amounts (sales proceeds) received by an option dealer from sales of "put" and "call" options which were written (issued or granted) by others and held by him for sale to his customers in the ordinary course of his business as such dealer, nor to amounts (commissions or fees) received by an option broker for selling "put" and "call" options for his principals as such broker.

I. T. 3835, C. B. 1947-1, 53, I. T. 2266, C. B. V-1, 13 (1926), and O. D. 1028, C. B. No. [*3] 5, 83 (1921), modified.

Reconsideration has been given to the second and third holdings in I. T. 3835, C. B. 1947-1, 53, in order to attain realistic treatment, for Federal income tax purposes, of "put" and "call" option transactions such as are therein involved. For the same reason, reconsideration has also been given to O. D. 1028, C. B. No. 5, 83 (1921), and the third holding in I. T. 2266, C. B. V-1, 13 (1926). Further, it is to be noted that gain realized by an optionor from the failure of the optionee to exercise such options is ordinary income under the Internal Revenue Code of 1954, whereas, as set forth in the first holding in I. T. 3835, *supra*, it was short-term capital gain under *section 117 (g) (2) of the Internal Revenue Code of 1939*.

I. T. 3835, C. B. 1947-1, 53, held, under the Internal Revenue Code of 1939, (1) that the amount (premium) received by the seller (writer) of a "put" or "call" option which is not thereafter exercised constitutes a short-term capital gain, under *section 117 (g) (2)* of that Code, to be taken into account in computing gross income, for Federal income tax purposes, only for the year in which the failure to exercise the option becomes final; (2) [*4] that, "Where the 'put' or 'call' is exercised, the amount received by the seller (writer) constitutes a reduction in the cost or other basis of the securities with respect to which the option is exercised for the purpose of determining gain or loss"; and (3) that the conclusions reached in holdings (1) and (2) "do not apply to amounts received from the sale of 'puts' or 'calls' which are written by dealers in securities in the ordinary course of their business."

O. D. 1028, C. B. No. 5, 83 (1921), held, under the Revenue Act of 1918, that an "amount received by the taxpayer to bind the option to acquire an interest in the profits from royalties that may accrue from the processes or patents in question is taxable income to the recipients for the year in which received." Presumably, the option had not expired without being exercised in the taxable year of receipt of the option premium involved.

I. T. 2266, C. B. V-1, 13 (1926), held, under the Revenue Act of 1924, (1) that the cost of a "put" to sell stock should not be entered as a part of the purchase price of any particular block of stock but should be carried to a deferred account as a capital expenditure made in an incompleted transaction [*5] entered into for profit; (2) that the cost of "puts" which were not exercised may be taken as allowable deductions in the taxable year in which they expire by limitation of time; and (3) that, "On sale of the stock 'put', the cost of the 'put' should be reallocated and added to the cost of the stock with respect to which it was exercised for the purpose of determining gain or loss on the sale."

Section 61 of the Internal Revenue Code of 1954 provides, generally, that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) certain specified items.

Section 1234 of the Internal Revenue Code of 1954 provides as follows:

> Gain or loss attributable to the sale or exchange of, or loss on failure to exercise, a privilege or option to buy or sell property which in the hands of the taxpayer constitutes (or if acquired would constitute) a capital asset shall be considered gain or loss from the sale or exchange of a capital asset; and, if the loss is attributable to failure to exercise such privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired. This section shall not apply to losses [*6] on failure to exercise options described in *section 1233 (c)* [relating to gains and losses from short sales].

The option rights and obligations here concerned generally are relatively simple options, usually assignable, *to sell* (generally termed "puts"), or *to buy* (generally termed "calls"), certain property, usually securities or commodities, at a stipulated price on or before a specified future date or within a specified future period of time, usually 30, 60, or 90 days, or 6 months, but sometimes longer, granted by the writer (issuer or optionor) to the holder (optionee) for a consideration, usually a cash payment (generally termed "premium"). Such option contracts terminate automatically upon expiration if they are not exercised. Upon their timely exercise, they are terminated, as such, but they become contracts of sale and purchase wherein the rights and obligations provided in the option contracts in the event of timely exercise are embodied.

Option rights and obligations are sometimes referred to as "privileges," stemming from the choice or privilege which their holders (optionees) have of exercising them. Hence, the term "privilege," as used in *section 1234, supra,* is considered [*7] synonymous with the term "option," as also used therein, and not to refer to any materially different rights or obligations.

Whether "puts" and "calls" are assignable or not is considered to be immaterial for the purposes here concerned, so, also, is whether "put" or "call" options are exercisable within a specified period of time (sometimes referred to as "ordinary") or on or before a specified date (sometimes referred to as "special").

If a "put" or "call" option is purchased from an original optionee, or assignee, rather than from the optionor, such option purchaser, as option holder, is also an optionee, and the amount paid by him for the option constitutes an option premium paid, insofar as he is concerned. However, in such case, the seller is not an optionor (writer or issuer); nor is the amount, though received by him for the option, a premium received for granting (writing or issuing) the option, but is an amount realized by him upon its disposition to be taken into account in computing gain or loss from the sale of the option as an asset.

Where "put" or "call" options are issued through an option broker, commissions or fees usually are charged for handling the transactions. In [*8] such cases, it may not definitely appear whether the commissions or fees were charged to the option issuer (writer or optionor), to the option purchaser (optionee), or to both. For example, in a common such transaction, the purchaser of the option (optionee) pays $137.50 for a 30-day "call" option on 100 shares of corporate stock; and the option writer (issuer or optionor) receives $112.50 for granting the option. However, for Federal income tax purposes, the total amount ($137.50) thus paid by the option purchaser (optionee) for the option is considered the (total) premium which he paid to acquire the option, and the net amount ($112.50) thus received by the option writer (issuer or optionor) is considered the (net) premium which he received for granting the option. Compare *Helvering v. Robert C. Winmill, 305 U. S. 79, 83 L. Ed. 52, 59 S. Ct. 45, 1938-2 C.B. 212,* Ct. D. 1365, *C. B. 1938-2, 212*; *Adolph B. Spreckels v. Helvering, 315 U. S. 326,* Ct. D. 1547, C. B. 1942-1, 198.

Probably most "put" and "call" options involving securities are for corporate stocks. Under common past practice, the holder (optionee) of a corporate stock "put" option, upon exercising it, became obligated to [*9] deliver to the optionor (writer or issuer) or his designated agent, in addition to the stock involved, the *amount* of all, regular and extra, cash dividends, and also all subscription rights, that accrued with respect to the stock during the option period, without receiving any additional or increased option price. Conversely, under such practice, the holder (optionee) of a corporate stock "call" option, upon exercising it, became entitled to receive from the optionor, in addition to the stock involved, the *amount* of all, regular and extra, cash dividends, and also all subscription rights, that accrued with respect to the stock during the option period, without paying any additional or increased option price. Under common current practice, the "put" option price is, under the terms of the option, adjusted (reduced) by the amount of such dividends and the value of such subscription rights, and the optionee-seller need not deliver such amount and such subscription rights in addition to the stock. Conversely, under such practice, the "call" option price is, under the terms of the option, adjusted (reduced) by the amount of such dividends and the value of such subscription rights, and the [*10] optionee-buyer is not entitled to such amount and such subscription rights in addition to the stock. Where "put" or "call" option prices are thus adjusted (reduced) on account of such interim cash dividends and subscription rights, the transactions are not complicated, for Federal income tax purposes, by their occurrences, since, in such cases, the seller of the stock involved simply receives therefor the adjusted (reduced) option price, in addition to the option premium received, and retains, or need not deliver, the amount of such dividends and also such subscription rights; and the buyer of the stock simply pays therefor the adjusted (reduced) option price, in addition to the option premium paid. However, where the seller of corporate stock, upon either a "put" or "call" option being exercised, must deliver the *amount* of such dividends and also such subscription rights, without becoming entitled to any additional or increased option price, the effect is that the seller receives for the stock and such subscription rights the option price, in addition to the option premium received, less the amount of such dividends that he delivers with the stock and such subscription rights; and [*11] the buyer pays for the stock and such subscription rights the option price, in addition to the option premium paid, less the amount of such dividends that he receives with the stock and such subscription rights. In all such cases, such dividends, to the extent that they constitute taxable dividend income, are includible in the gross income of whomsoever owned the stock when its holder became entitled to the dividend, or dividends, as such. See, generally I. T. 4007, C. B. 1950-1, 11; *Rev. Rul. 56-153, C. B. 1956-1, 166*; and *Rev. Rul. 56-211, C. B. 1956-1, 155*; *cf. Rev. Rul. 54-399, C. B. 1954-2, 279*.

Certain "put" and "call" corporate stock option contract forms now extensively used provide for "endorsement" on the reverse side thereof by a member of the New York Stock Exchange, and for exercising such options by delivery of the stock involved in a "put" option to such endorser, or by call on such endorser for the stock involved in a "call" option, instead of by delivery to, or by call on, the option writer (issuer or optionor) himself. Also, in such forms, directly above the line provided for the signature of the writer, it is stated, "The undersigned acts as intermediary only, without [*12] obligation other than to obtain a New York Stock Exchange firm as Endorser." However, such endorser-firms require the writers of such "put" options to deposit with them, for payment to the optionees in the event of exercise, cash in the amount of the option price, and require the writers of such "call" options to so deposit, for delivery to the optionees in the event of exercise, the stock involved. Thus, the writer of such "put" or "call" options is actually a real optionor (and neither dealer nor broker), and the endorser-firm is his trustee-agent and surety (and not the optionor), with respect to them.

Usually, the premium paid for either a "put" or a "call," is not, under its terms or otherwise, applicable, if it is exercised, against its option price, but it is sometimes so provided in "call" options. However, it is considered unrealistic to distinguish, for the purpose of determining proper Federal income tax treatment, between an option whereunder the amount of the premium is applicable, in such event, against the option price and one whereunder the amount of the premium is not so applicable, since there is no real difference between them. Their substance is the same, and their [*13] formal difference involves merely a different way of stating the (real) option price. For example, a 90-day "call" option granted for a $500 premium to buy certain stock at $10,000 with no provision for applicability of the premium there against in the event of exercise of the option is, in reality and substance insofar as option price is concerned, identical with a 90-day "call" option granted for $500 premium to buy the same stock at $10,500 with the $500 premium paid applicable there against in the event of exercise of the option. The real option price is the same in both options, namely $10,000. The decision in *Virginia Iron, Coal & Coke Co., 37 B. T. A. 195*, affirmed *99 F. (2d) 919*, certiorari denied *307 U. S. 630*, is not to the contrary despite certain *dicta* contained in the opinions.

An optionor, by the mere granting of an option to sell ("put"), or buy ("call"), certain property, may not have parted with any physical or tangible assets; but, just as the optionee thereby acquires a right to sell, or buy, certain property at a fixed price during a specified future period or on or before a specified future date, so does the optionor become obligated to accept, or deliver, such [*14] property at that price, if the option is exercised. Since the optionor assumes such obligation, which may be burdensome and is continuing until the option is terminated, without exercise, or otherwise, there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option. The open, rather than closed, status of an unexercised and otherwise unterminated option to buy (in effect a "call") was recognized, for Federal income tax purposes, in *A. E. Hollingsworth v. Commissioner*, *27 B. T. A. 621*, acquiescence, C. B. XII-1, 6 (1933). It is manifest, from the nature and consequences of "put" or "call" option premiums and obligations, that there is no Federal income tax incidence on account of either the receipt or the payment of such option premiums, *i.e.*, from the standpoint of either the optionor or the optionee, unless and until the options have been terminated, by failure to exercise, or otherwise, with resultant gain or loss. The optionor, seeking to minimize or conclude the eventual burden of his option obligation, might pay the optionee, as consideration for cancellation of the option, an amount equal to or [*15] greater than the premium. Hence, no income, gain, profits, or earnings are derived from the receipt of either a "put" or "call" option premium unless and until the option expires without being exercised, or is terminated upon payment by the optionor of an amount less than the premium. Therefore, it is considered that the principle of the decision in *North American Oil Consolidated v. Burnet*, *286 U. S. 417, 76 L. Ed. 1197, 52 S. Ct. 613, 1932-1 C.B. 293*, Ct. D. 499, C. B. XI-1, 293 (1932), which involved the receipt of "earnings," is not applicable to receipts of premiums on outstanding options.

G. C. M. 23677, C. B. 1943, 370, held, under the Internal Revenue Code of 1939, that gain or loss arising from the *sale* (not writing, issuing, or granting) of an option to acquire stock (in effect a "call") to a person other than the owner of the stock subject to the option, is long term capital gain or loss, *provided* such option was a "capital asset" (as defined in *section 117 (a) (1)* of that Code) in the hands of the vendor and had been held by him for more than six months. In other words, if the vendor of the option were an option dealer and the option had been held by him primarily for sale [*16] to customers in the ordinary course of his business as such dealer, the gain or loss to him from its sale would constitute ordinary gain or loss, because, in such case, the option would not have been a "capital asset" (as so defined) in his hands.

The first holding in I. T. 3835, *supra*, namely, that the amount (premium) received by the writer (issuer or optionor) of a "put" or "call" option which is not exercised constitutes a short-term capital gain, under *section 117 (g) (2) of the Internal Revenue Code of 1939*, to be taken into account in computing his gross income, for Federal income tax purposes, only for the taxable year in which the failure to exercise the option becomes final, is considered to be correct under that Code.

However, it is to be noted that *section 117 (g) (2) of the Internal Revenue Code of 1939* specifically provided that gains* * * attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains* * *," whereas in the Internal Revenue Code of 1954 there is no corresponding or other provision under which such gains shall or may be considered or treated as capital gain, either short-term or long-term. Therefore, [*17] it is held that the amount (premium) received by the writer (issuer or optionor) of a "put" or "call" option which is not exercised constitutes ordinary income, for Federal income tax purposes, under *section 61 of the Internal Revenue Code of 1954*, to be included in his gross income only for the taxable year in which the failure to exercise the option becomes final.

As aforestated, O. D. 1028, *supra*, held that "an amount received by the taxpayers to bind the option to acquire an interest in the profits from royalties that may accrue from the processes or patents in question is taxable income to the recipients for the year in which received," *i.e.*, even though the option period had not expired therein with failure to exercise the option. Insofar as that ruling may be deemed to relate to a true premium received for granting a bona fide and arm's-length option to acquire an interest in a patent or processes, it is considered to be unrealistic and in conflict with the foregoing holdings that the amount (premium) received by the writer (issuer or optionor) of a "call" option which is not exercised constitutes gain or income only for the taxable year in which the failure to exercise becomes [*18] final, and is modified to hold that such a premium is not taxable income when received but is taxable income if and when the option expires without being exercised. See, in this connection, *Revenue Ruling 57-40, C.B. 1957-1, 266*.

The second holding in I. T. 3835, *supra*, namely that, where a "put" or "call" option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it constitutes "a reduction in the cost or other basis of the securities with respect to which the option is exercised for the purpose of determining capital gain or loss," is not clearly stated insofar as it relates to "put" options and is considered to be unrealistic insofar as it relates to "call" options. Realistically, where a "put" option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it constitutes an offset against the option price, which he paid upon its exercise, in determining his (net) cost basis of the securities that he purchased pursuant thereto, for subsequent gain or loss purposes. In other words, the securities purchased by the writer (issuer or optioner) of the "put" option, upon its exercise, actually cost him, not the [*19] option price which he paid pursuant thereto, but such price less the amount (premium) which he received when he granted the option. Also, realistically, where a "call" option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it is includible by him, with the option price, which he received upon its exercise, in the (total) amount realized for the securities that he sold pursuant thereto, for purposes of determining his gain or loss on their sale. In other words, an amount (premium) received for granting a "call" option does not constitute to the writer (issuer or optionor) an adjustment (reduction) of the cost or other basis of his securities involved in the option, regardless of whether or not the option is exercised; but, where such option is exercised, he actually realizes for the securities, not merely the option price that he received upon their sale pursuant thereto, but also the amount (premium) which he received when he granted the option. Accordingly, the second holding of I. T. 3835, *supra*, is modified to hold that, where a "put" option is exercised, the amount (premium) received by the writer (issuer or optioner) for granting it [*20] constitutes an offset against the option price, which he paid for the securities involved upon its exercise, in determining the (net) cost basis to him of the securities that he purchased pursuant thereto, for subsequent gain or loss purposes; and that, where a "call" option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it is includible by him, with the option price, which he received for the securities involved upon its exercise, in the (total) amount realized by him for the securities that he sold pursuant thereto, for the purpose of determining his gain or loss on their sale. For the latter purpose, if the amount (premium) received for granting a "call" option is, under its terms, applicable, upon its exercise, on, to, or against the option price specified therein, such price thus adjusted (reduced) is considered the real option price.

The third holding in I. T. 3835, *supra*, namely that the first and second holding of that ruling "do not apply to amounts received from the sale of 'puts' and 'calls' which are written by dealers in securities in the ordinary course of their business," is considered to be inaccurate and misleading. A "dealer" [*21] is a merchant, whether in merchandise, commodities, securities, or options. A person clearly is not engaged as an option dealer in "writing" (issuing or granting) options for premiums, since such activity plainly is not "sale" in the sense of an option dealer (merchant) selling to his customers in the ordinary course of his business as such dealer. However, as G. C. M. 23677, *supra*, reasonably implies, an option dealer can, as such, buy and sell options written (issued or granted) by someone else, which may include options of which he is the original optionee provided they are held by him for sale to his customers in the ordinary course of his business as such dealer. Some persons or firms, who also may be option dealers, are option brokers, particularly with respect to "ordinary" options (issued for specified periods, rather than having specified expiration dates). They, as such brokers, are merely agents in buying and selling options for their principals, who may be optionors or optionees, or both, and for such services they usually receive commissions or fees. Upon reconsideration, the third holding of I. T. 3835, *supra*, is modified to hold that its first holding, and its second [*22] holding (as hereinbefore modified), do not apply to amounts (sales proceeds) received by an option dealer from sales of "put" and "call" options which were written (issued or granted) by others and held by him for sale to his customers in the ordinary course of his business as such dealer, nor to amounts (commissions or fees) received by an option broker for selling "put" and "call" options for his principals as such broker.

The third holding in I. T. 2266, *supra*, namely that, "On the sale of the stock 'put', the cost [premium] of the 'put' should be reallocated and added to the cost of the stock with respect to which it was exercised for the purpose of determining gain or loss on the sale," is considered to be an unrealistic application to the option holder (optionee), upon exercise of a "put" option, of the premium which he paid for it, although the end result may be the same as if a realistic rule had been applied. While a premium paid for a "put" option is properly taken into account in determining gain or loss to the option holder (optionee) on sale of the optioned property pursuant to exercise of the option, such premium should not be added to his cost or other basis of such property, [*23] but should be offset against the option price, which he received for such property, in computing the (net) amount realized by him therefor, for the purpose of determining his gain or loss on its sale. In other words, the premium paid for the "put" option was not acquisition or other cost of the property sold pursuant thereto by the optionee upon its exercise, but was cost to him of obtaining the sum specified therein as the sale (option) price, and, thus, the (net) amount realized by him for the property was the amount of such price less that cost. It has been held, conversely, that where an option to buy property (in effect a "call") is exercised, the option cost (premium) should be included by the optionee, with the option price thereupon paid or accrued, in determining the (total) cost basis to him of the property that he purchased pursuant thereto, for subsequent gain or loss purposes. See *Realty Sales Co. v. Commissioner, 10 B. T. A. 1217,* acquiescence C. B. VII-2, 33 (1928). Upon reconsideration of the third holding in I. T. 2266, *supra*, it is modified to hold that, on the sale by the option holder (optionee) of the stock involved in a "put" option, upon its exercise, the cost [*24] (premium) of the option to him should be offset against the option price, thereupon received or accrued, in computing the (net) amount realized by him for the stock that he sold pursuant thereto, for the purpose of determining his gain or loss on its sale.